meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a good quarter for sterling based investors with significant unhedged overseas exposure, whilst, for US dollar and euro based investors, there have been very modest positive returns. Bond investors have enjoyed positive returns, too, as bond yields have descended to even more extraordinary levels. The feature of the foreign exchange market has been significant sterling weakness driven by political fears. Gold has been a strong performer on the back of all the political uncertainty which exists at present and the prospect of still lower interest rates.

The tables below detail relevant movements in markets :

International Equities 30.04.19 - 31.07.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.0	+13.6	+6.4	+7.4
Finland	-1.9	+3.7	-2.6	-1.9
France	+1.2	+7.0	+0.5	+1.2
Germany	-1.9	+3.8	-2.5	-1.9
Hong Kong, China	-3.7	+2.8	-3.5	-2.8
Italy	+0.2	+6.0	-0.5	+0.2
Japan	-3.2	+5.8	-0.7	N/C
Netherlands	+0.5	+6.3	-0.1	+0.5
Spain	-4.3	+1.2	-5.0	-4.3
Switzerland	+3.1	+13.0	+6.1	+6.8
UK	+3.2	+3.2	-3.1	-2.5
USA	+1.7	+8.3	+1.7	+2.4
All World Europe ex UK	+0.5	+7.1	+0.6	+1.2
All World Asia Pacific ex Japan	-1.9	+4.2	-2.1	-1.5
All World Asia Pacific	-2.4	+4.8	-1.6	-0.9
All World Latin America	+1.4	+11.2	+4.5	+5.2
All World All Emerging Markets	-2.3	+5.0	-1.4	-0.8
All World	+0.7	+7.1	+0.6	+1.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +5.0%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	30.04.19	31.07.19
Sterling	1.12	0.60
US Dollar	2.53	2.03
Yen	-0.07	-0.18
Germany (Euro)	-0.10	-0.52

Sterling's performance during the quarter ending 31.07.19 (%)

Currency	Quarter Ending 31.07.19
US Dollar	-6.3
Canadian Dollar	-8.2
Yen	-8.6
Euro	-5.6
Swiss Franc	-9.0
Australian Dollar	-4.0

Other currency movements during the quarter ending 31.07.19 (%)

Currency	Quarter Ending 31.07.19
US Dollar / Canadian Dollar	-2.0
US Dollar / Yen	-2.5
US Dollar / Euro	+0.8
Swiss Franc / Euro	+3.7
Euro / Yen	-3.0

Significant Commodities (US dollar terms) 30.04.19 - 31.07.19 (%)

Currency	Quarter Ending 31.07.19
Oil	-10.0
Gold	+11.4

MARKETS

International equity markets have edged higher this quarter although, for internationally invested sterling based portfolios, the result has been strong as sterling has depreciated over the quarter. In total return terms, the FTSE All World Index returned +0.7% in local currency terms, +7.1% in sterling terms, +0.6% in US dollar terms and +1.3% in euro terms. Looking at local currency returns first, the outstanding performer was Australia where the FTSE Australia Index returned +9.0%. The UK and US markets showed above average performances with the FTSE UK Index returning +3.2% and the FTSE USA returning +1.7%. On the downside, the FTSE Japan Index (-3.2%), the FTSE All World Asia Pacific Index (-2.4%), the FTSE All World Asia Pacific ex Japan Index (-1.9%) and the FTSE All World Emerging Markets (-2.3%) underperformed. In sterling terms, the picture is quite different. The FTSE UK Index's return of +3.2% was well below that of the +7.1% return of the FTSE All World Index. The outstanding performance again came from Australia with the FTSE Australia Index returning +13.6%. Other notable performances came from the FTSE USA Index (+8.3%), the FTSE All World Europe ex UK Index (+7.1%) and the FTSE All World Latin America Index (+11.2%). Because of the strength of the yen, the negative local currency performance of the FTSE Japan Index became +5.8% in sterling terms.

International bond markets also rose during this period. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK gilt fell by 52 basis points to 0.60%, that on the US Treasury bond by 50 basis points to 2.03%, that on the JGB by 11 basis points to -0.18%. Also going further into negative territory was the German Bund where the negative gross redemption yield widened further by 42 basis points to -0.52%. We will be discussing the phenomenon of negative yields later in this review.

As indicated above, sterling weakened considerably over the period on Brexit and political fears. Against the Swiss Franc sterling fell by 9.0%, against the yen by 8.6%, against the Canadian dollar by 8.2%, against the US dollar by 6.3% and against the euro by 5.6%.

In the commodity markets, oil, as measured by Brent crude, fell by 10.0% on the back of weakening economic growth, whilst gold rose by 11.4% reflecting its traditional role as a store of value in uncertain times. There was effectively no opportunity cost arising from holding gold, given where interest rates are at present.

ECONOMICS

The economic background is deteriorating although not at a rate which yet suggests a recession. This might seem strange given the strength of international equity markets yet we believe this apparent paradox can be explained.

First, however, let us look at the economic background as set out in the latest IMF World Economic Outlook published in July. Compared with its April 2019 projections, it now sees world growth this year at 3.2% against 3.3%. That is not a significant move but follows on from earlier downgrades. For Advanced Economies, it actually sees a higher growth figure than in April, 1.9% against 1.8%. The USA is responsible for this. The IMF has upgraded its April projection by 0.3% so that it now sees US growth in 2019 at 2.6%. There is no change in its projection for the euro area at 1.3%. There is a minor downgrade for Germany of 0.1% to 0.7%, an astonishing figure for the powerhouse of the eurozone, whilst the projection for Spain is raised by 0.2% to 2.3%. The projection for the UK has been slightly upgraded by 0.1% to 1.3%. The only other change has been for Japan where the IMF now projects 2019 growth at 0.9%, a downgrade of 0.1% on its April projection. The largest downgrades have been in Emerging Markets and Developing Economies where the downgrade has been by 0.3% to 4.1%. For China, the reduction has been minor, by 0.1% to 6.2%. For India, it has been larger, by 0.3% to 7.0%. Elsewhere, there has been a significant reduction in the IMF's projection for Brazil, one of 1.3% to 0.8%. Mexico, too, has seen a sharp reduction, by 0.7% to 0.4% and South Africa by 0.5% to 0.7%. The projection for Russia is 1.2%, a downgrade of 0.4%.

These downgrades, whilst disappointing, are not disastrous and it is not difficult to find the cause. We have outlined the problems in all of our recent economic reviews and they persist. Developing trade disputes, notably, but not only, between the USA and China are damaging and slow down the level of international trade. The ineffectiveness of monetary policy in stimulating or sustaining economic growth or helping to meet inflation targets and, nearer home, uncertainty over Brexit and the UK political situation, have cast a shadow over the economy, not only in the UK but in the EU as well. Nevertheless, on an international scale, Brexit is not as important as the first two issues except for sterling based investors and this is who we are largely talking about.

Economically, we are living in surreal times which, in terms of the stock market, has provided a positive catalyst for asset prices which is not a good quality one. Whilst equities remain our favoured asset class, we are very alive to this. Monetary policy has propelled asset prices higher, but one can only see it becoming less effective as central bankers run out of policy ammunition. The eurozone is the main area of concern where the IMF is forecasting 1.3% growth this year. Whilst that is a low figure, by itself it is not disastrous, but the concern is that very recent economic data suggests quite significant weakness, including in the eurozone's economic powerhouse, Germany. This has caused the ECB, where Mr Draghi is entering his final days as President of the ECB, to indicate further easing of monetary policy. The ECB's deposit facility currently stands at -0.4%. This is quite penal for banks and any lowering of interest rates could worsen the situation for them, although the ECB may find a way to ease their pain, at least partially. Quantitative easing may be restarted and there has even been speculation that this may include equities' purchases, as has happened in Japan through the purchase of equity exchange traded funds. This is, however, a step too far for the ECB in all probability and Germany would certainly object. Two questions arise from the possibility of further monetary easing, one short term one and one longer term one. The short term one is that, given where interest rates are in the eurozone at present, is a small adjustment and/or more quantitative easing likely to make any noticeable difference to economic activity? The longer term one is that, if further action is necessary more than ten years after the financial crisis, does it not point to a deeper malaise in the eurozone and elsewhere because it seems to be increasingly less effective as a policy?

For bonds and equities, the extreme monetary policy which has been followed since the financial crisis, has been good news. Quantitative easing and very low or negative interest rates increase the attraction of income paying assets. In major markets the attraction of dividend yields relative to bank deposit rates is considerable in absolute terms. In most markets, dividend yields are well in excess of bond yields. In the USA, the yield on the ten year US Treasury bond which was slightly in excess of the dividend yield on the S & P 500 index has now fallen below it. It may seem fairly obvious to compare the dividend yields on shares with bond or cash deposit yields and to conclude that shares must be the preferred asset class, other things being equal, but an alternative view, widely held, is that the shape of the yield curve, the relationship between very short term yields and longer term yields, typically those on ten year government bonds, presages a recession. The thinking here would be that one would normally be expected to be rewarded with a higher return for investing longer because of greater credit risks and the possibility/probability of inflation eating into nominal returns. If a pessimist expects a recession, leading to the central banks reducing short term interest rates, then it may be logical to invest in longer term bonds to lock in yield, thereby driving down long term bond yields below those of short dated instruments like Treasury Bills before the latter's interest yield reduces.

Judging by market movements since the US yield curve turned negative, the pessimists have been on the wrong side of the argument. One reason why a downward sloping yield curve may not presage a recession is that the market has been heavily distorted by quantitative easing and the messages the yield curve is sending is misleading. This is our view and we believe the relative or absolute yield advantage of equities against fixed interest and cash has been a powerful contributor to the strong performance of equities.

Whilst equities have performed well, so, too, have bonds, yet another unusual situation and, again, most likely a function of monetary policy. At present, there is around US$13.5 trillion of bonds showing a negative gross redemption yield representing a quarter of all investment grade bonds. This is extraordinary. As this is written and looking at ten year government bond yields, we can see negative yields on ten year government bonds from France, Germany, Sweden, Netherlands, Switzerland and Japan. Why would anyone pay a government or a top quality corporate to lend money to them? Why would anyone who held negative yielding bonds to redemption be happy to lose money? One short term argument is momentum and the greater fool theory. If everyone knows that an asset is expensive but think they can squeeze some profit out of it before the music stops, they may try to do this. For instance, if a bond was bought on a -0.3% gross redemption yield and sold on a -0.4% yield, a profit could be made, even though buying it in the first place could have made no fundamental sense. The investor who was willing to buy at a -0.4% yield would look very foolish if there was any move towards mean reversion. Only a gambler would take this action. An investor who took an apocalyptic view of the world economy might also be tempted on the basis that the only safe investments were government bonds and the prospect of not receiving all of one's investment back was preferable to losing one's money in a bank or any other type of investment. In such a scenario, deflation may well take hold because of a lack of demand and, therefore, a nominal loss on a bond investment could mean a real gain if the rate of deflation exceeded the negative yield on a bond. But we are really stretching credulity to believe that this is a realistic economic scenario. There are, of course, always investors who have to hold bonds whatever their rates of return and they provide a steady source of demand but for those who don't, they have to ask very seriously why they would buy them. When sentiment eventually turns in the bond markets, things could get very messy.

At least in the equity markets, if there is a setback, prices will almost certainly recover at some stage and move ahead. That has been the history of shares and long term holders have been well rewarded. Whilst one can argue whether shares are overvalued at present, very few would say that they are extremely overvalued. The opposite is true of fixed interest securities. Many, and we are amongst them, feel that they are extremely overvalued and that, if interest rates reverse as they are bound to at some time, the fall in bond prices will only ever have a partial reversal once interest rates have reached the peak of their next cycle and current prices and yields are unlikely to be seen again. That is the difference between equities and bonds.

Why is it that over ten years on from the financial crisis and economic recession, the world economy finds itself in its current state dependent on ultra low or negative interest rates to keep even modest growth levels going? One is increasing levels of indebtedness both amongst governments and individuals. As debt grows, so servicing costs increase and weigh on national or individual budgets. This is a headwind for growth as money available for spending is restricted. The situation would be even more difficult if interest rates were at anything like normal levels. Low servicing costs on debt issued since interest rates were at emergency levels have particularly masked the effect of the debt build up, but the effect cannot be put off for ever and will be a problem for the future. One of the many distortions arising from current monetary policy is that low debt servicing costs enable zombie companies to keep going because they can service interest payments even if they cannot repay the principal. This crowds out companies with superior growth prospects and reduces an economy's potential growth rate. However, for higher quality borrowers, if rates do turn it will probably come with higher inflation which will make incredibly low current nominal rates even more affordable for borrowers if they are locked into these favourable rates.

During this period, inflation has been stubbornly low. This might seem a very strange complaint, especially in the UK, which, at times in the past, has suffered from very high inflation with all the economic damage which this causes. Low inflation is certainly not as bad but it does have malign economic consequences. Japan has been a good example of this over the years where, at times, deflation has existed. If prices are falling or hardly moving upwards, there is less incentive to buy goods which are not immediately necessary. This subdues economic activity and a vicious downward economic spiral can ensue. Since the financial crisis started, the recession and, then, low inflation has had a depressing effect on real incomes. In the UK, which, in certain respects, is in a good economic position with strong employment levels, the phenomenon is almost certainly part of the poor productivity record. It has been cheaper for companies to hire people than to invest. Rising productivity is the desired route to increases in real incomes and through that to economic growth. So, some central banks are in the unusual position of trying to achieve an inflation target and finding it difficult to do so. So, back to the Japanese position, and the thinking there is that, if Japanese consumers can be put in a mindset where the expectation is that prices will rise rather than fall, they will be motivated to spend sooner rather than later in order to avoid price increases, rather than the other way round as has been the case. From a business perspective, companies would be more likely to invest if they felt that their employment costs were going to rise, thereby paving the way for higher productivity.

The area where the interest rate issue and growth problem is most acute is the eurozone and it is likely that at least part of the reason is the euro. The eurozone as a whole runs a large current account surplus at around 3.5% of GDP. Within that total, Germany's current account surplus is an eye watering 6.5% of GDP and the Netherlands, although a much smaller economy, 10.1% of GDP. There are probably two major reasons for this. One is the single currency. In a freely floating exchange rate environment, countries like Italy, which have steadily lost competitiveness since the euro was founded, cannot make an exchange rate adjustment to compensate for relative cost increases and, therefore, lose competitiveness. With this adjustment mechanism not available and the requirements of the Stability and Growth Pact, which it is supposed to meet, the inevitable consequence is weak demand and, therefore, weak growth, which is why the ECB has followed such an aggressive monetary policy. On the other side of the fence is a country like Germany where the lack of a freely floating currency within the euro area has meant that the country has become increasingly competitive, helping to create this huge current account surplus. There is also another factor. Germany's strict constitutional limits on its federal budget deficit (0.35% of GDP at a structural level) means that the country has not been willing to embark on a fiscal stimulus which could have the dual effects of raising demand in its own economy, reducing the size of the current account surplus and raising demand levels elsewhere in the eurozone. The problem in the eurozone is deficient demand and that is partly as a result of the disadvantages of a single currency. There are, of course, two sides to economic policy, monetary and fiscal. Because of the constraints of the Stability and Growth Pact, there is only limited scope for fiscal expansion, so monetary policy is having to do the heavy lifting and it has resulted in this extraordinary position in which we now see ourselves. It is a very unhealthy state of affairs to see interest rates where they are today. Besides the zombie company effect and its depressing effect on economic growth, which we talked about earlier, it has all sorts of undesirable side effects. They distort asset allocation, reduce the effectiveness of price discovery, can cause asset price bubbles, encourage investors to take undue risks in terms of yield, leading to the type of scandals which we read about in the newspapers, and increase the costs for businesses in relation to their pension schemes to name but some.

The shift in position on monetary policy is remarkable. The USA's economy has been performing well and the Federal Reserve had been steadily raising interest rates until late 2018 and there was an expectation that there would be two or three more interest rate increases this year and more next year until we probably reached the peak of this current cycle. In a complete turnabout, which was signalled in January and March, interest rates in the USA are now heading lower and we have just seen the first cut of 0.25% to give a federal funds target rate of 2.00% to 2.25% and this in an economy which is likely to perform quite well this year, as the IMF's projections show. Unlike the eurozone, fiscal policy can do a lot of heavy lifting for the US economy and President Trump has already make significant tax cuts and the US is running a large budget deficit, estimated to be getting on for 5% of GDP this year. But with US Treasury bonds offering positive yields, yield hungry investors have been happy to buy US debt. Running large budget deficits is building up trouble for the future but, at the moment, have been partly responsible for the decent US growth figures.

As this is being written, President Trump has now ramped up further the pressure on China by proposing a 10% tariff on a further US$300 billion of imports from the 1st September. This will mean that practically all of the USA's imports from China will be affected by tariffs. Protectionism is bad. It causes economic distortions and is negative for consumer welfare. It slows down economic growth. Whilst tariffs and quotas might be the most eye catching forms of protectionism, subsidies are another and this is a bugbear of the USA as it feels that it is not competing on a level playing field particularly in China. It is difficult to know how this stand off between the USA and China will end. Neither side can be seen to back down. It is obviously a concern because economic growth and world trade will be affected which will have a knock on result on real disposable incomes, company profitability and dividends.

Finally, the third issue, which we mentioned at the beginning of this review is the UK's political situation and Brexit. As we have often mentioned, we regard the political risks in the UK to be greater than Brexit because of the possibility of a government being elected with an extreme economic manifesto by UK standards. Brexit, especially departure from the EU without an agreement, will certainly cause problems, but they are likely to be overcome. The political risk is the longer term and more important issue in our view. It seems increasingly likely that there will be a General Election in the UK with one of the stipulations of the Fixed Term Parliament Act being met. This will probably be the loss of a no confidence motion but no one able to form a government which commands a majority in the House of Commons. As things stand, the most probable result is an indecisive one which would create considerable uncertainty, not least in terms of economic policy but, of course, that may change. To misquote Donald Rumsfeld, there are known unknowns and unknown unknowns in the UK and it remains a high risk area, so substantial overseas unhedged exposure represents a sensible insurance against UK risks. That remains the case, even with sterling at current depressed levels. In other circumstances, the UK stock market and currency would look cheap, but it is too early to bet on an outcome which would reverse the situation. This is the main issue informing our investment policy at present for sterling based investors.

So, overall, given the drivers of markets at present, how do we sum up the situation as far as investment policy is concerned? One thing we feel most confident about saying is that bonds look very poor value and carry a high performance risk when interest rates start to reverse as they will sometime. The economic risks of inflation erupting, although it does not feel like it at present are, are significant down the line. We see negative real interest rates in many countries. Cash has a role for the extremely risk averse although, in real terms, it will mean a loss each year. Where we are largely fully invested in equities, we have allowed cash to build up through dividend receipts, hoping to invest at lower levels, but we have not gone further than this in holding cash. So, it is back to equities. We should certainly not get carried away by equities' performance so far in 2019. The first quarter largely reversed the poor fourth quarter of 2018 when investors were concerned about the prospect of rising US interest rates and the trade war between the USA and China. We remain largely fully invested with a strong emphasis on non UK assets because we do accept the attraction of the relative yield argument between bonds/cash and equities in the context of stable or falling interest rates. It will be a bumpy ride given the trade war background so the returns so far in 2019 must not be considered indicative of the rest of the year and there has been weakness in early August as President Trump has raised the tariff stakes and China has reacted. We do not consider shares so expensive that we should risk reducing exposure to that asset class for long term investors who form our client base.